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RUEHBU/AMEMBASSY BUENOS AIRES 3954
RUEHSG/AMEMBASSY SANTIAGO 5449
RUEHAC/AMEMBASSY ASUNCION 5371
RUEHMN/AMEMBASSY MONTEVIDEO 6191
RUEHME/AMEMBASSY MEXICO 1961
RUEHCV/AMEMBASSY CARACAS 3211
RUEHBO/AMEMBASSY BOGOTA 3711
RUEHQT/AMEMBASSY QUITO 1789
RUEHLP/AMEMBASSY LA PAZ 4522
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TAGS: ECON EFIN PGOV PREL BR
SUBJECT: BRAZIL AT A FISCAL INFLECTION POINT?

REF: A) BRASILIA 665 B) BRASILIA 608

¶1. (SBU) Summary: The Lula administration heretofore has compiled an impressive record of fiscal rectitude, routinely posting primary budget surpluses well beyond its formal 4.25 percent of GDP target. This performance has allowed the GoB to reduce its net-debt-to-GDP ratio (from 57.2% in 2003 to about 51.6% at end 2005). While these results have been commendable, the GoB achieved them primarily through higher tax revenues, which grew due to tax reforms in 2003 and income tax growth based on the strong profitability of certain economic sectors in 2004/2005. Though Lula reduced real expenditures in his first year in office, revenue growth since then has meant that expenditure growth has been much less constrained in subsequent years. Revenue growth may now have reached an inflection point, with March 2006 revenues falling ever so slightly (0.04%) in real terms from March 2005 levels. Newly appointed Finance Minister Guido Mantega publicly reiterated on April 19 that the Gob would sequester whatever expenditures it must in order to meet its 4.25% of GDP primary surplus target. However, if stagnant revenue trends continue, this will exacerbate the political battles surrounding fiscal policy in Brazil, and will likely become one of the key points of debate in this presidential election year. Fiscal and tax reform will thus become an urgent issue for the new administration in January 2007. End Summary.

Revenue Growth Down

¶2. (U) GoB federal tax revenues in the first quarter of 2006 grew much more slowly (1.7% in real terms) than in the two previous years, while March revenues were down 0.04% from March 2005 levels. The GoB's obligatory expenditures (e.g. government payroll, social security, earmarked health expenditures), however, are expected to continue to grow apace. Revenues administered by Receita Federal (Brazil's IRS equivalent - this measure of revenues excludes payroll taxes that are paid directly to the Social Security system) likely

will fall from 17.2% of GDP in 2005 to 16.8% of GDP this year, while obligatory expenditures climb from 15.5% of GDP to 17.1% (obligatory expenditures include payroll, earmarked health expenditures, social assistance, government employee pensions and social security expenses). Overall, it accounts for about 90% of central government expenditures). Broader data for the central government as a whole (i.e. including the social security system but excluding states and municipalities) shows that in the first two months of 2006, revenues as a percent of GDP were essentially unchanged (26.28% of GDP in 2006, vs. 26.25% of GDP in 2005) while expenditures grew from 17.84% of GDP to 19.05% of GDP in the same period.

Federal Fiscal Snapshot
Percent of GDP

Revenues	2002	2003	2004	2005	2006 /1
Administered Revenues (tax)	16.3%	15.6%	16.2%	17.2%	16.8%
+ Social Security Income	5.3%	5.2%	5.3%	5.6%	5.6%
+ Other Income	2.5%	2.4%	3.1%	3.1%	2.6%
- Transfers to States/Cities	3.9%	3.8%	3.7%	4.5%	4.1%
Equals Net Central Govt. Revenues	20.2%	19.3%	20.4%	20.1%	20.6%

Expenditures	2002	2003	2004	2005	2006 /1
Total Expenditures	18.0%	17.2%	17.8%	19.1%	18.4%
Obligatory Expenditures	15.6%	15.8%	15.4%	15.5%	17.1%
- of which Social Security	6.4%	6.9%	7.1%	7.58%	7.93%
- of which Fed Payroll and Benefits	5.6%	5.1%	5.1%	4.85%	4.92%
Federal Gov. Primary Surplus/2	2.4%	2.5%	3.0%	2.9%	2.3%

/1 - Predicted 2006 values
/2 - Does not include state, municipal and parastatal company contribution to the public sector primary surplus
-Sources: Planning Ministry, Finance Ministry, Raul Velloso

¶3. (SBU) A well-known private sector budget consultant, Raul Velloso, noted to Econoff in an April 13 conversation that the drop in revenue growth and increasing obligatory expenditures mean the GoB's discretionary expenditures (currently about 10% of total expenditures, including investments, operating expenses such as fuel for vehicles, communications, etc.) would be dramatically squeezed this year. He thought that the GoB would have a hard time meeting the 4.25% of GDP primary surplus target. Indeed, GoB data shows the central government primary surplus (excluding states and parastatals, which contribute towards the overall public sector primary surplus) dropped from 3.59% of GDP in the first two months of 2005 to 2.33% of GDP in 2006. This is partly to be expected, according to Velloso, since in an election year the GoB typically

concentrates expenditures prior to the election-law-mandated June 30 cut-off on new investments. The problem, Velloso argued, was that falling revenue growth meant revenues would not cover the continued growth in obligatory expenditures (fed, among other factors, by Lula's minimum wage increase, which impacts both Central Government and social security accounts). Velloso feared that the GoB would not be able to make up the difference in the second half of the year.

¶4. (SBU) Velloso - who it must be noted has strong ties to the opposition PSDB - explained that previous years' strong revenue growth was due to a series of one-off events. These included the revamping of the PIS and COFINS taxes in 2003 to make them more VAT-like. Accordingly, the effect of this reform, which increased the effective rates of these taxes, diminished after 2004. 2005 saw strong profitability in the commodity-based sectors of the Brazilian economy, which significantly boosted income tax revenues paid by firms such as mining giant CVRD. These effects were unlikely to be repeated, Velloso argued. Moreover, in the second half of 2005 the GoB implemented legislation granting targeted tax breaks for capital investments, the effects of which were now becoming perceptible. For example, from March 2005 to March 2006 revenues generated by the IPI, a federal VAT on manufactured products, fell 7.65 percent.

Mantega: "Anyone Betting Against Us Will Lose Money"
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¶5. (U) Newly appointed Finance Minister Guido Mantega has used recent public appearances to reiterate forcefully that the GoB will fulfill its 4.25% of GDP primary surplus target. Testifying along with Planning Minister Paulo Bernardo at the April 18 presentation of the 2007 Budget Directives Law (i.e., the LDO, a multi-year budget framework document) to Congress, Mantega insisted the GoB would meet the target this year. The LDO, moreover, maintains the 4.25% primary surplus target unchanged for 2007, 2008 and 2009. In an April 19 interview with daily Estado de Sao Paulo, Mantega blamed the lower primary surplus for the first months of 2006 not on reduced revenue growth, but rather on the election year-related need to spend in the first half of the year, as well as unusually high carry-over spending from the end of 2005. Mantega pledged the GoB would sequester whatever expenditures necessary from the just-approved 2006 budget to meet the 4.25% of GDP target. He dismissed the idea of the GoB attempting to over-perform the target, however, as it had repeatedly done under his predecessor, Antonio Palocci.

¶6. (U) Background Note: Budget fulfillment is not mandatory in Brazil. Indeed, in an acrimonious annual exercise, the administration is required to walk back whatever unrealistic revenue, GDP growth, interest rate or exchange rate assumptions that the Congress inserts in the budget law and sequester corresponding expenditures in order to ensure the primary surplus target is fulfilled. With the April 18 approval of the 2006 budget, the GoB within the next weeks should issue a decree identifying budgeted expenditures that must be sequestered. In prior years, public investment spending has accounted for the great majority of spending targeted for sequestration. Sequestered expenditures can be liberated later if revenues exceed the administration's expectations. End Note.

¶7. (SBU) Separately, Mantega and Bernardo highlighted an LDO provision that calls for current expenditures to be cut by 0.1% of GDP per year over the next three years (down from the budgeted 2006 level of 17.71% of GDP). The GoB hopes to achieve this through a requirement, which would take effect immediately upon the LDO's approval, that all recurring spending commitments (such as new hiring) must receive prior authorization from both the finance and planning ministries. Hiring discipline has been a problem for the Lula administration. March 2006 data showed that the Lula administration had created a total of 37,543 new federal jobs, 2,268 of which are to be filled through presidential appointment. This in part reflects Lula's reversal of policy of the previous two governments to outsource jobs wherever possible and reduce the public payroll via attrition. A little less than a quarter of the

new federal jobs were created to staff new regulatory agencies.

Market Views

¶8. (SBU) Most analysts believe the GoB will meet the 4.25% of GDP target. The chief economists of several Brazilian and foreign banks told visiting Treasury A/S Clay Lowery on April 4 that they expect the GoB to do so. Separately, Banco Itau Executive Director (and former Central Bank director) Sergio Werlang told the press that while he believes the GoB will meet the target for the calendar year, it is likely that the rolling twelve-month primary surplus will dip below 4.25% of GDP at some point this year. Markets, he said, will take that as a bad sign, and it would perhaps slow Brazil's march towards an investment grade credit rating. Gustavo Loyola, who recently left his job as a Central Bank director for the private sector, chastised market participants for fixating on the primary surplus, which he argued should not have become an end in itself, but rather was simply an anchor for policies aimed at reducing the debt-to-GDP ratio. Not enough attention was being

paid, he said, to reducing the nominal deficit or to the quality of expenditure.

¶9. (SBU) Loyola's point on the quality of expenditure is an oft-repeated one. The rigid structure of the GoB budget, with constitutionally mandated transfers to states and municipalities, along with earmarked expenditures on items such as health and a large social security deficit (about 2% of GDP in 2005) financed out of general revenues, mean that investments and operating expenditures must bear the brunt of fiscal adjustment. The GoB anticipates, for example, that federal discretionary expenditures including investments will fall from 3.29% of GDP in 2005 to 2.82% in 2006. In its first years, the Lula administration advanced measures that could make up for the shortfall in public investment spending and ameliorate the public infrastructure deficit, notably the Public Private Partnerships (PPP) legislation which was passed in December 2004. Despite the fanfare that greeted its passage, implementation has been slow and the GoB has yet to put out for tender any PPP projects. The private sector is increasingly concerned about the infrastructure gap, predicting that Brazil may well face energy shortages in the medium term (2008/2009) due, in part, to the GoB's problematic overhaul of the energy sector regulatory framework in 2004/2005.

¶10. (SBU) Comment: The falling growth in revenues, if it proves a more durable trend, stands to exacerbate the always lively and sometimes acrimonious fiscal policy debate. As several contacts have observed to us, the first step to cutting through Brazil's budgetary Gordian knot is to bring current expenditures under control, which has been problematic for the Lula administration. The 2007 LDO contains some useful measures aimed at doing so, but with the Lula administration continuing to beat off corruption scandals even as it tries to prepare for the October 2006 elections, there is little hope that it will make hard decisions on longer-term expenditure constraint. Instead, it will likely just muddle through the remainder of the year, trying to placate both the markets and its political constituencies. The GoB has both the tools and the political will to meet the primary surplus target (as we expect it ultimately will), but the fiscal dynamics involved mean it will occur at further cost to the quality of public expenditure. Fiscal and tax reform, therefore, will need to be at the top of new administration's agenda come January 2007.

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